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Report Highlights: New Zealand's milk production during the 2003/04 season is forecast to increase 2.5 percent to 14.7 million tons. Fonterra forecasts a 9 percent increase in its final producer payout for the current season of NZ\$ 3.95 per kg. MS. Exports of cheese, butter, skim and whole milk powder are forecast to increase 3 percent to 1.675 million tons. Good export sales potential continues to favor a shift in Fonterra's product mix to milk powder and processing capacity for both skim and whole milk powder is being expanded.

Includes PSD Changes: Yes
Includes Trade Matrix: Yes
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SECTION I. EXECUTIVE SUMMARY

New Zealand's milk production during the 2003/04 season (June-May) is forecast to increase 2.5 percent to 14.7 million tons. Changes in weather conditions during the peak and late dairy season, however, can significantly impact final production levels. This season's milk production increase is attributed to a 1.5 percent growth in the national dairy herd and a recovery in per cow productivity. With farmer payout levels for the current season, and most likely for the year to follow, expected to remain below NZ \$4.00 (1 U.S. \$ = NZ \$1.71) per kg. of milk solids (MS), New Zealand's dairy farmers will proceed cautiously in maximizing their production capacity. Fonterra is now forecasting a final milk payout for the 2003/04 season of NZ\$ 3.95 per kg. MS, up 9 percent over the 2002/03 payout of NZ \$3.63. Producer efforts to maximize production in recent seasons when payouts were considerably higher (i.e. 2000/01 and 2001/02) are now being directed at increasing efficiency, lowering production costs, and improving profitability. The total number of dairy farm conversions during the current 2003/04 season is estimated at 42 compared to more than 80 last season and around in 2001/02.

More than half of Fonterra's dairy production in the 2003/04 season will consist of milk powder because of a relatively higher return compared with butter, cheese and casein. Total cheese, butter, skim milk powder and whole milk powder exports in 2003/04 are forecast to increase 3 percent to 1.675 million tons thanks in part to a more balanced international supply and demand picture and stronger export price levels. Post forecasts that cheese production will remain stable, but exports will decline 3 percent. Butter production and exports in the 2003/04 season are forecast to increase 4 and 2 percent, respectively. With Asian demand showing strength, production and exports of non-fat dry milk powder are forecast to increase 6 and 11 percent, respectively. Whole milk powder production and exports are forecast to increase 2 percent. Industry analysts anticipate a continued recovery in export price levels for whole milk powder over the medium-term thanks to expanded usage for milk reconstitution. With a positive outlook for milk powder, Fonterra has announced plans to significantly increase its milk powder production capacity.

Fonterra continued the consolidation of its international supply base by increasing its 25 percent stake in the Australian (Victoria-based) Bonlac Supply Company Limited to 50 percent. This will assist Fonterra in reaching long-term supply arrangements with its global customers who increasingly seek security of supply by obtaining multiple supply sources. In a parallel event, Dairy Farmers of America (DFA) and Fonterra have concluded a memorandum of understanding which solidifies their business partnership. The two co-operatives already have a joint venture, DairiConcepts, which combines DFA's manufacturing sites with Fonterra's technological innovations and R&D. The memorandum of understanding will aid in identifying mutual business interests and the pursuit of common investment objectives for the two companies. Fonterra will benefit from enhanced access to the American market while DFA will be assisted in exporting its dairy surpluses, particularly cheese.

A study commissioned by New Zealand Trade and Enterprise (a Government agency created by the merger of Trade New Zealand and Industry New Zealand) recently quantified value-added food and beverage product exports for various food sectors. According to the study, approximately 35 percent of the total export returns generated by the New Zealand dairy industry was accounted for by value-added products, with the remainder contributed by butter and milk powder sales. Leading in New Zealand is the meat industry, which generates 51 percent of its export returns from value-added products.

SECTION II. STATISTICAL TABLES

PSD Table: Fluid Milk

PSD Table						
Country	New Zealand					
Commodity	Dairy, Milk, Fluid				(1000 HEAD)(1000 MT)	
	2002	Revised	2003	Estimate	2004	Forecast
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]
Market Year Begin		06/2001		06/2002		06/2003
Cows In Milk	3749	3749	3953	3842	0	3900
Cows Milk Production	13925	13925	14346	14346	0	14705
Other Milk Production	0	0	0	0	0	0
TOTAL Production	13925	13925	14346	14346	0	14705
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	13925	13925	14346	14346	0	14705
Intra EC Exports	0	0	0	0	0	0
Other Exports	48	47	60	47	0	45
TOTAL Exports	48	47	60	47	0	45
Fluid Use Dom. Consum.	355	355	360	360	0	360
Factory Use Consum.	13480	13480	13884	13895	0	14255
Feed Use Dom. Consum.	42	43	42	44	0	45
TOTAL Dom. Consumption	13877	13878	14286	14299	0	14660
TOTAL DISTRIBUTION	13925	13925	14346	14346	0	14705
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	0	0	0	0	0	0

PSD Table: Cheese

PSD Table						
Country	New Zealand					
Commodity	Dairy, Cheese				(1000 MT)	
	2002	Revised	2003	Estimate	2004	Forecast
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]
Market Year Begin		06/2001		06/2002		06/2003
Beginning Stocks	43	43	50	51	14	20
Production	312	312	272	285	0	285
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	1	0	2	0	5
TOTAL Imports	0	1	0	2	0	5
TOTAL SUPPLY	355	356	322	338	14	310
Intra EC Exports	0	0	0	0	0	0
Other Exports	277	277	280	290	0	280
TOTAL Exports	277	277	280	290	0	280
Human Dom. Consumption	28	28	28	28	0	28
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	28	28	28	28	0	28
TOTAL Use	305	305	308	318	0	308
Ending Stocks	50	51	14	20	0	2
TOTAL DISTRIBUTION	355	356	322	338	0	310
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	38	38	50	50	0	40

PSD Table: Butter

PSD Table						
Country	New Zealand					
Commodity	Dairy, Butter				(1000 MT)	
	2002	Revised	2003	Estimate	2004	Forecast
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]
Market Year Begin		06/2001		06/2002		06/2003
Beginning Stocks	50	50	51	51	50	29
Production	370	370	390	390	0	405
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	420	420	441	441	50	434
Intra EC Exports	0	0	0	0	0	0
Other Exports	343	343	365	386	0	395
TOTAL Exports	343	343	365	386	0	395
Domestic Consumption	26	26	26	26	0	26
TOTAL Use	369	369	391	412	0	421
Ending Stocks	51	51	50	29	0	13
TOTAL DISTRIBUTION	420	420	441	441	0	434
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	27	27	19	22	0	18

PSD Table: Non-Fat Dry Milk Powder

PSD Table						
Country	New Zealand					
Commodity	Dairy, Milk, Nonfat Dry				(1000 MT)	
	2002	Revised	2003	Estimate	2004	Forecast
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]
Market Year Begin		06/2001		06/2002		06/2003
Beginning Stocks	98	98	100	100	80	106
Production	255	255	295	325	0	345
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	353	353	395	425	80	451
Intra EC Exports	0	0	0	0	0	0
Other Exports	248	248	310	314	0	350
TOTAL Exports	248	248	310	314	0	350
Human Dom. Consumption	5	5	5	5	0	5
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	5	5	5	5	0	5
TOTAL Use	253	253	315	319	0	355
Ending Stocks	100	100	80	106	0	96
TOTAL DISTRIBUTION	353	353	395	425	0	451
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	1	1	2	2	0	2

PSD Table: Dry Whole Milk Powder

PSD Table						
Country	New Zealand					
Commodity	Dairy, Dry Whole Milk Powder			(1000 MT)		
	2002	Revised	2003	Estimate	2004	Forecast
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]
Market Year Begin		06/2001		06/2002		06/2003
Beginning Stocks	20	20	33	78	2	57
Production	540	540	585	615	0	630
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	560	560	618	693	2	687
Intra EC Exports	0	0	0	0	0	0
Other Exports	526	481	615	635	0	650
TOTAL Exports	526	481	615	635	0	650
Human Dom. Consumption	1	1	1	1	0	1
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	1	1	1	1	0	1
TOTAL Use	527	482	616	636	0	651
Ending Stocks	33	78	2	57	0	36
TOTAL DISTRIBUTION	560	560	618	693	0	687
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	4	4	3	3	0	3

Trade Matrix: Cheese

NEW ZEALAND DAIRY EXPORTS				
Calendar Years				
CHEESE (tons)				
Destination	2000	2001	2002	2003*
United States	32,356	38,203	47,742	21,268
Japan	49,955	54,599	44,459	19,847
Australia	31,484	40,170	40,128	20,037
Belgium	16,367	19,057	19,169	17,425
United Kingdom	11,625	14,832	17,016	8,644
Mexico	10,466	11,292	13,462	6,745
Korea, South	9,132	12,056	10,307	5,605
Saudi Arabia	5,301	8,281	9,737	5,032
Algeria	5,970	6,407	7,756	2,098
Egypt	5,727	6,508	6,190	1,641
Taiwan	6,158	4,955	5,953	2,984
Hong Kong	3,732	4,314	3,854	1,684
Philippines	2,818	2,457	3,324	1,693
Jamaica	4,755	5,736	3,324	1,853
Venezuela	2,884	4,091	3,218	964
Malaysia	2,346	2,893	3,014	1,682
Panama	1,195	2,869	2,684	1,148
Indonesia	1,650	1,635	2,338	982
Guatemala	495	1,213	2,333	1,277
Netherlands	879	7,450	2,300	770
Trinidad & Tobago	1,003	1,842	2,293	1,328
Other	31,618	26,569	28,288	13,704
TOTAL	237,915	277,430	278,888	138,410
Source: Statistics New Zealand				
* January - June				

Trade Matrix: Butter

NEW ZEALAND DAIRY EXPORTS				
Calendar Years				
BUTTER (tons)				
Destination	2000	2001	2002	2003*
Belgium	41,605	34,701	68,938	39,137
Iran	30,238	15,225	33,623	17,052
Egypt	24,417	24,095	32,928	9,989
Russia	7,183	3,656	24,801	10,454
Mexico	17,461	21,011	23,415	7,054
United States	19,711	26,598	21,049	12,397
Latvia	15,374	15,565	20,349	0
United Kingdom	39,019	37,613	18,885	0
Canada	11,408	18,113	14,401	5,902
India	7,104	617	11,569	1,342
Taiwan	10,597	8,971	10,829	5,056
Morocco	7,016	5,938	8,951	3,253
Singapore	16,023	4,914	7,658	2,521
Thailand	2,407	3,915	7,487	3,416
Saudi Arabia	6,593	5,170	7,049	4,797
Algeria	2,834	5,184	6,346	676
Australia	9,822	10,065	6,337	3,584
Indonesia	3,638	3,803	6,278	2,317
Hong Kong	6,784	8,845	5,985	1,715
China	613	1,346	5,847	4,313
Philippines	5,225	4,534	5,452	4,825
United Arab Emirates	11,330	4,453	4,826	2,754
Denmark	3,866	5,061	4,808	2,739
Malaysia	4,763	4,480	4,541	2,266
Japan	238	290	4,215	120
Vietnam	4,768	3,039	4,030	1,749
Other	38,454	26,132	30,333	12,735
TOTAL	348,491	303,335	400,930	162,166
Source: Statistics New Zealand				
* January - June				

Trade Matrix: Non-Fat Dry Milk Powder

NEW ZEALAND DAIRY EXPORTS				
Calendar Years				
NON-FAT DRY MILK POWDER (tons)				
Destination	2000	2001	2002	2003*
Japan	13,714	18,513	29,740	6,968
Mexico	3,174	4,414	25,538	485
Philippines	20,271	29,480	25,223	23,065
Indonesia	14,004	18,686	24,200	7,854
Thailand	5,851	15,277	23,444	6,617
Malaysia	20,804	24,727	20,895	10,831
China	5,981	7,061	20,084	11,537
Taiwan	16,805	19,789	14,250	6,296
Vietnam	5,900	9,301	13,664	4,930
Algeria	0	315	13,101	505
Saudi Arabia	11,834	11,170	12,650	8,509
Germany	0	0	12,533	0
Belgium	0	159	12,047	48
Netherlands	132	369	8,905	0
Singapore	4,075	3,084	8,206	8,345
Cuba	0	10,167	6,346	5,312
Hong Kong	9,848	9,669	5,246	2,265
Egypt	3,333	4,760	4,349	2,050
Sri Lanka	3,022	2,150	4,304	2,161
Peru	4,887	4,201	4,169	1,361
Myanmar	2,253	3,194	4,100	535
Yemen, Rep of	1,995	2,857	3,305	916
Venezuela	3,333	4,432	2,679	344
South Africa	188	36	1,990	23
Canada	180	935	1,845	870
Korea, South	880	1,130	1,741	664
United States	638	936	1,485	702
Australia	3,609	3,308	1,483	3,994
Other	9,384	15,166	16,249	8,315
TOTAL	166,094	225,285	323,772	125,502
Source: Statistics New Zealand				
* January - June				

Trade Matrix: Whole Milk Powder

NEW ZEALAND DAIRY EXPORTS				
Calendar Years				
WHOLE MILK POWDER (tons)				
Destination	2000	2001	2002	2003*
China	23,547	29,638	55,874	45,253
Malaysia	57,241	41,606	47,955	23,721
Indonesia	39,155	46,250	39,841	26,812
Philippines	18,976	27,100	32,331	23,677
Sri Lanka	27,705	31,857	30,331	18,771
Saudi Arabia	17,035	20,495	26,227	14,118
Mexico	3,588	37,393	25,506	20,998
Thailand	28,873	27,242	25,307	18,292
Venezuela	29,954	44,895	21,738	12,310
Taiwan	17,750	20,944	21,658	10,005
Canada	9,857	10,989	20,666	12,265
Cuba	3,044	10,864	15,939	8,011
Algeria	7,618	7,589	15,903	7,703
Singapore	16,848	6,737	15,560	8,734
Vietnam	20,339	56,974	14,196	17,757
El Salvador	16,193	17,419	14,106	6,849
Jordan	0	500	13,584	4,168
United Arab Emirates	8,174	5,965	8,699	2,429
Australia	6,997	6,769	8,602	4,201
Oman	993	753	8,599	3,511
Japan	2,363	4,761	8,214	6,194
Bangladesh	2,925	3,235	6,478	2,513
Brazil	2,994	1,026	6,279	282
Guatemala	27	3,150	5,430	2,375
Peru	10,726	7,959	5,283	2,641
Kuwait	5,130	5,185	5,267	981
Hong Kong	15,396	10,403	3,742	1,369
Dominican Republic	2,672	4,113	3,589	2,281
Mauritius	3,302	3,844	3,423	2,868
United States	3,990	3,421	3,409	1,122
Other	22,131	23,757	34,535	15,989
TOTAL	425,545	522,834	548,270	328,200
Source: Statistics New Zealand				
* January - June				

SECTION III. PRODUCTION

Milk Production

New Zealand's dairy industry forecasts milk production during the 2003/04 season (June-May) at 14.7 million tons, up 2.5 percent over a year earlier. The increase is based upon higher per cow productivity following a dip in average animal yield last season, a modest increase in dairy cow numbers from the 42 dairy farm conversions this year in the South Island, and an increase dairy cows on existing farms.

As of late September, milk volume is running 3 - 4 percent ahead of last season's pace. Peak milk production is set to occur between October 22 to 26 in the North Island and November 4 to 5 in the South Island. During these peak periods, daily national milk production is projected to reach a record 75 million liters. Changes in weather conditions during the peak and late dairy season can significantly impact total seasonal milk output.

Herd Statistics

New Zealand's dairy herd at the beginning of the 2003/04 season is estimated to have grown 1.5 percent to 3.9 million animals. The number of dairy farm conversions as well as the expansion of existing operations is slowing as the cost of both entering the industry and increasing production capacity rises. New dairy farm operations, as well as existing farms which opt to increase their production, are obligated to make a payment to Fonterra of NZ\$ 4.38 (up 14 percent on the previous season) for every additional kilogram of milk solids (MS) they produce this season¹. While current price signals from Fonterra indicate better milk payouts for the 2003/04 season, up nearly 9 percent over the 2002/03 payout of NZ \$3.63 per kg. MS, Fonterra warns that its exchange rate hedging regime will not fully cover sales returns from the 2004/05 season. If the New Zealand dollar continues its appreciation against the U.S. dollar, farmer payouts for 2004/05 could fall below the 2002/03 season. This would further constrain growth in dairy cow numbers.

2003/04 Season Production Outlook

More than half of Fonterra's dairy production in the 2003/04 season will consist of milk powder because of a relatively higher return compared with butter, cheese and casein. While cheese and casein price levels are normally higher, they require more milk solids and energy to produce. Low milk powder stocks, a strong purchasing demand, improving prices, and a positive sales outlook for the Chinese market favors a shift in product-mix in favor of milk powder production. Since November 2002, milk powder prices have increased 20 percent. Over the same time period, butter prices have risen modestly, while cheese and casein prices have fallen slightly. In New Zealand dollar terms, prices for milk powder and butter are 25 to 28 percent lower than in the 2001/02 season. Cheese and casein prices, however, have fallen 38 percent. According to Fonterra, milk powder represented the most efficient use of milk solids during 7 out of the last 10 years.

The positive outlook for milk powder has motivated Fonterra to commission a new milk drier in Southland at its Edendale plant and a new whole milk powder drier at its Clandebye plant in South Canterbury. They are scheduled to begin operating in the 2004/05 season. Aware of a U.S. export intervention price of U.S. \$1,800 per ton, Fonterra seeks to ensure that its milk powder production remains price competitive.

Total cheese, butter, skim and whole milk powder exports in 2003/04 are forecast to increase 3 percent to 1.675 million tons thanks in part to a more balanced international supply and

¹ Unless they are not a Fonterra supplier.

demand situation, improved export price levels, and a reduced dairy production in Australia due to drought conditions. With combined production increasing 50,000 tons, total dairy stock levels are projected to decline 65,000 tons during the current season.

Cheese

Post forecasts cheese production in the 2003/04 season to be stable at 285,000 tons. Export volume, however, is projected to decline 3 percent to 280,000 tons. End-of-season stocks will be reduced significantly. Current season export prices for New Zealand's cheese products are less attractive relative to market prices for powders and butter, and a delay in the recovery of cheese prices is anticipated as European production remains high. Industry sources expect that Fonterra, therefore, will continue to shift its product-mix emphasis towards milk powder production.

Butter

Post forecasts butter production in the 2003/04 season to increase 4 percent to 405,000 tons. International prices for butter have improved and exports are expected to increase modestly to 395,000 tons. Butter stocks will decrease as a reflection of increasing exports.

Non-Fat Dry Milk Powder

Production of non-fat dry milk powder during the 2003/04 season is forecast to increase 6 percent to 345,000 tons. Asian demand for non-fat dry milk powder is likely to remain strong and exports overall are forecast to increase 11 percent to 350,000 tons. While international prices for non-fat dry milk powder have improved, the local industry anticipates that prices will be affected by the USDA's intervention price. Some price weakness is expected in the medium-term. This reflects the continued loss of share of the milk reconstitution market to whole milk powder.

Whole Milk Powder

Whole milk powder production in 2003/04 is forecast to increase 2 percent to 630,000 tons. Exports of whole milk powder are expected to increase by a similar margin to 650,000 tons. This will lead to a significant reduction in whole milk powder stocks. Industry analysts expect that export price levels for whole milk powder will continue to recover at a moderate rate over the medium-term thanks to its expanded use for milk reconstitution. The increasing 'westernization' of the diets of Asian and non-OECD nations combined with economic growth and rising incomes in these countries will support this trend.

Farmgate Prices

Fonterra forecasts a final payout for the 2003/04 season of NZ\$ 3.95 per kg. MS up 9 percent on the 2002/03 payout of NZ \$3.63. The increase is attributed to improved world prices, especially for milk powders and butter. However, a continued depreciation of the U.S. dollar is likely to be reflected in forward exchange rates beyond the current 15 months timeframe², thereby affecting 2004/05 payouts.

² At this point in time, Fonterra has hedged all sales returns for a period of 15 months at rates of U.S. \$0.56 to 0.58. A NZ \$.06 gain against the U.S. dollar would reduce per kg. MS payouts by NZ \$0.50.

Fonterra Increases Milk Powder Production Capacity in the South Island

Fonterra has announced plans to expand its Clondeboy South Island processing site with a new milk powder drier. According to Fonterra, the drier will significantly increase its milk powder capacity once it begins operating in the 2004/05 season. Based on a daily drying capacity of 3.7 million liters of milk, the drier could add approximately 60,000 tons of whole milk powder annually to Fonterra's production. The drier is strategically placed in the Canterbury region of the South Island where milk volumes are expected to increase 6 percent annually over the next 5 years.

A new drier with an annual capacity of 50,000 tons of either skim or whole milk powder has been commissioned at the Edendale plant in Southland where it will help to absorb the milk from an additional 30 new suppliers. This has the potential to increase Edendale's production from 160,000 to 210,000 tons annually. The new driers enable Fonterra more regional product-mix flexibility to respond faster to changing market signals.

Westland Increases Milk Production and Independence

Westland produced 352 million liters of milk in the 2002/03 season, up 4 percent over the prior season. Westland's output represented 2.5 percent of national production. With an additional 13 suppliers this season, Westland's production is forecast to increase 10 percent. Since the dairy industry merger in 2001, Westland has continuously reduced its reliance on the former New Zealand Dairy Board's marketing structure, which was essentially adopted by Fonterra. While Westland sold 90 percent of its production through Fonterra in the first season after deregulation, this fell to 40 percent in the 2002/03 season. Westland is emerging as an independent milk producer and marketer and it now plans to sell dairy products to Fonterra rather than through Fonterra.

Westland seeks to be a high-quality ingredient supplier, aiming at expanding sales of high-value, nutritional and ingredient products. For example, high-priced lactoferrin sold to the Tatua dairy. Its higher payout (NZ \$3.97 per kg. MS in the 2002/03 season versus Fonterra's NZ \$3.63) is in part attributable to low reject rates. All of its butter production and 99.7 percent of its powder production achieved the highest quality grade in previous seasons. Westland's forecast payout for the 2003/04 season is NZ \$4.00 per kg. MS.

SECTION IV. INTERNATIONAL MARKETING***Fonterra Strengthens Australian Supply Base***

Farmer shareholders of the Australian (Victoria-based) Bonlac Supply Company Limited agreed to restructure Bonlac Foods Limited by increasing Fonterra's shareholding in Bonlac Foods from 25 to 50 percent. Under a restructuring agreement, Fonterra will take over the management of Bonlac Foods. Fonterra will purchase all of Bonlac Foods' dairy production and assumes responsibility for all of Bonlac Foods sales and marketing activities. Fonterra benefits from the increased shareholding by diversifying its supply base. This will aid Fonterra in securing long-term supply arrangements with its global customers, many of whom seek supply security through multiple supply sources. Fonterra's increased ownership position in Bonlac Foods effectively merges Fonterra and Bonlac's ingredients marketing operations for the Asian region. Bonlac is Australia's largest ingredients business, but recently has been struggling financially. Fonterra ensured that its 25 percent shareholding and strategic stake in the Australian market was not jeopardized by competitor consolidation in the Australian market. For example, a merger between Australia's Murray Goldbourn and Bonlac would have created a business entity which controlled 80 percent of Australia's exports and 50 percent of Australian production.

Dairy Farmers of America and Fonterra Advance Relationship

Fonterra and Dairy Farmers of America (DFA), the largest milk co-operative in the United States, have signed a memorandum of understanding to cement their partnership for the future. The two co-operatives already have a joint venture arrangement based in the United States, DairiConcepts, which combines DFA's manufacturing sites with Fonterra's technological innovations and R&D. The 50:50 joint venture produces specialty powders for infant formula, high-end cheese powder, snack seasoning, prepared foods and food service as well as milk protein concentrate. Sales in 2003 are expected to reach NZ \$500 million to customers such as Nestlé, Frito-Lay, Kraft, Unilever and Mead Johnson. The memorandum of understanding formalizes the existing arrangement to identify mutual business interests and pursues investment objectives of common interest. Fonterra will gain enhanced access into the American market while DFA will be aided in its efforts to export its dairy surpluses, particularly cheese.

Study Assesses Level of Value-Added Production in New Zealand Exports

A study commissioned by New Zealand Trade and Enterprise, a Government agency created by the merger of Trade New Zealand and Industry New Zealand, to quantify value-added food and beverage exports found that 35 percent of total dairy export value is categorized as value-added. The study divided all primary food and beverage sectors into seven groups: meat, dairy, fruit and vegetable, seafood, cereals, beverage and miscellaneous industries. With regard to the New Zealand dairy sector, the study concluded that the dairy industry is quite successful at developing new products and reducing processing costs. Most of New Zealand's dairy export value is contributed by butter and milk powder sales, which are widely regarded as commodities. The dairy industry is ranked number two by the study behind the meat industry, which exports 51 percent in value-added form. The study showed that the proportion of New Zealand's value-added product exports remained static overall as a proportion of total exports.

SECTION V. INDUSTRY ISSUES***Fonterra's 'Peak Notes' Scheme Stays***

Following feedback from its supplier shareholders and the Shareholders' Council, Fonterra proposed a simplified mechanism, the Capacity Adjustment Scheme, to replace Peak Notes to pay for extra processing capacity and equipment needed by Fonterra to process peak spring milk production. Under the Peak Notes scheme, suppliers need to hold a number of peak notes, which is proportional to the steepness of their supply curve during the peak supply period, which is normally around October/November. The peak period is defined as the 30 days prior to, and the 40 days after Fonterra's peak supply day. The formula used by Fonterra to calculate supplier's Peak Note requirements is very complex and this has been the source of concern to Fonterra shareholders. Thus Fonterra proposed the capacity adjustment scheme, which is easier to understand and administer. However, shareholder support of 75 percent was not achieved at the recent annual general meeting. The rejection of the capacity adjustment scheme came as a surprise given that so many farmers have opposed the Peak Notes scheme since Fonterra implemented it in its current form.

Fonterra admitted that the capacity adjustment scheme could be seen as favoring those farmers with a flatter production curve. Shareholder rejection of the proposal appears to be related to regional production differences and concerns by farmers of non-irrigated units who generally have steeper milk curves. Another issue may have been that the capacity adjustment scheme would have required suppliers with a flat production curve, usually those on irrigated land in the South Island, to make a one-time capital contribution to bring them up to the same capital level as other shareholders. At this point, it remains unclear whether

Fonterra will propose an alternative to the Peak Notes scheme and for the time being the Peak Notes scheme will remain in force.

Dairy Companies Association of New Zealand (DCANZ)

New Zealand's major dairy companies have established the Dairy Companies Association of New Zealand (DCANZ) to represent the manufacturing and marketing sectors of the dairy industry on domestic and international public policy issues. DCANZ consists of Fonterra Co-operative Group, Tatua Co-operative Dairy Company, Westland Co-operative Dairy Company, Mainland Products and New Zealand Dairy Foods. DCANZ will perform the role carried out previously by the former New Zealand Dairy Board. However, following the formation of Fonterra two years ago, there has been no formal joint representation or vehicle to liaise between the remaining independent dairy companies, with the Government, and other organizations. While not all New Zealand dairy companies are represented in DCANZ at present, as many as 150 other registered dairy companies will be invited to join. Members will pay for specific projects on a pro-rata basis and resources will be pooled to perform policy analysis to enable DCANZ to engage in advocacy with authorities in New Zealand and overseas. Other issues DCANZ will deal with include international trade liberalization issues, environmental management, and animal welfare practices.

Low Payouts Impact on New Zealand Dairy Farms

Last season's payout of NZ \$3.63 per kg. milk solids (MS) to Fonterra's suppliers and the outlook for only a modest payout improvement for the 2003/04 season of NZ \$3.95 per kg. MS places dairy farmers under increased financial pressure according to the Livestock Improvement Corporation (LIC). Taking into account that some farmers require a payout of NZ \$3.31 per kg. of MS to break even, LIC advises farmers to cut costs in areas that do not negatively impact on production. The main factor is that average farm expenditures are rising faster than increases in production and as a consequence average farm equity is falling. LIC advises dairy farmers to maintain fertilizer application rates and to continue using high-value genetic material rather than resort to less expensive but less productive natural breeding methods. Even once-a-day milking can, if used correctly, significantly reduce costs without seriously compromising production levels. The drive by dairy farmers to increase production during recent seasons when payouts were high (2000/01 and 2001/02) is now being overtaken by efforts to reduce costs, increase efficiency, and improve productivity.